

1974

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## Recommended Citation

Field, Harold D. Jr., "Resolving Shareholder Disputes and Breaking Deadlocks in the Close Corporation" (1974). *Minnesota Law Review*. 1427.

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## Resolving Shareholder Disputes and Breaking Deadlocks in the Close Corporation

Harold D. Field, Jr.\*

"All's love, yet all's law."

—Robert Browning

What happens when the shareholders of a close corporation<sup>1</sup> are no longer close?

At the time a close corporation is formed, or at the time a new owner joins the business by acquiring stock of the corporation, the participants tend to be friendly toward each other and enthusiastic about the prospects of the business. Indeed, they are often impatient with whatever detailed documentation counsel recommends to reflect their new relationship.<sup>2</sup> At a later date, however, enthusiasm, friendship and even family ties sometimes give way to hostility and deadlock. That impatiently tolerated formality, the governing legal documentation, then must be painstakingly reviewed to determine the rights of the warring factions. If the by-laws and the shareholders' agreement make no special provision for resolving disputes and breaking deadlocks, the rights of the factions must be determined under a legislative framework, which until recently has often failed to deal with the relationships and problems unique to the close corporation.<sup>3</sup> Thus a dissatisfied shareholder, unless the holder of a controlling or even a two-thirds interest,<sup>4</sup> may be locked into

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1. In a close corporation, the stock is held by a few shareholders who in most cases serve as the directors and key employees. For an attempt to define the term "close corporation" see Note, *Some Specific Needs of the Close Corporation Not Met Under the Minnesota Business Corporation Act: Suggestions for Statutory Relief*, 54 MINN. L. REV. 1008 & n.1 (1970). See also DEL. CODE ANN. tit. 8, § 342 (Cum. Supp. 1968).

2. The governing legal documentation consists of articles of incorporation, e.g., ABA-ALI MODEL BUS. CORP. ACT §§ 54-56 (2d ann. ed. 1971) [hereinafter cited as MODEL ACT]; corporate by-laws, e.g., MODEL ACT § 27; a shareholders' agreement, e.g., MODEL ACT § 34; and employment contracts with the shareholder employees. By this documentation, provisions are often made for shareholder representation on the board of directors, compensation of shareholder employees, and restrictions on the transferability of the shares of stock.

3. F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.01 (1971) [hereinafter cited as O'NEAL]. See note 4 *infra*.

4. Under most corporate statutes, a noncontrolling shareholder is

an ongoing relationship with business associates who will not agree to a separation on acceptable terms. Since no ready market exists for a noncontrolling stock interest in the typical close corporation, the dissatisfied shareholder is generally unable to find a third party willing to offer a fair value for the noncontrolling shares.<sup>5</sup>

This Article reviews four remedial arrangements to deal with the problems of dissension and deadlock among the principals in a close corporation: (1) a buy-out of one of the disputing parties, (2) an easy dissolution, (3) an arbitration, and (4) an appointment of a provisional (tie-breaking) director. As noted above, many existing statutes have not adequately recognized the close corporation, establishing instead general guidelines for the regulation of all corporations. Thus the thrust of much of this Article is prophylactic, to suggest that the shareholders in a close corporation make early arrangements for the treatment of possible future corporate acrimony. Initially, of course, the shareholders will try to resolve any conflict without resort to a remedial arrangement, which may strike at the structure, ownership and very existence of the corporation.<sup>6</sup> Failing

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not in a position to liquidate his holdings. Premised upon the regulation of large, publicly owned corporations, the corporate acts of most states require the assent of a majority or two-thirds of the shareholders prior to any "fundamental" or "organic" change in the corporate structure. By definition the noncontrolling shareholder is unable to muster the required votes.

For provisions covering the voting requirement prior to merger or consolidation see, e.g., MODEL ACT § 73 (majority); ARIZ. REV. STAT. ANN. § 10-344 (1956) (two-thirds); DEL. CODE ANN. tit. 8, § 251(c) (Cum. Supp. 1968) (two-thirds); MINN. STAT. § 301.42(2) (1971) (two-thirds, unless otherwise specified in the articles of incorporation, but not less than one-half). For the voting requirements prior to a sale of assets see, e.g., MODEL ACT § 79 (majority); DEL. CODE ANN. tit. 8, § 271 (Cum. Supp. 1968) (majority); MINN. STAT. § 301.36 (1971) (two-thirds, unless otherwise specified in the articles of incorporation, but not less than one-half); ANN. MO. STAT. § 351.400 (1966) (three-fourths); W. VA. CODE ANN. § 31-1-64 (1972) (60 percent). For the voting requirements prior to a voluntary dissolution see, e.g., MODEL ACT § 84 (majority); DEL. CODE ANN. tit. 8, § 275(b) (Cum. Supp. 1968) (two-thirds); MINN. STAT. § 301.47(1) (1971) (two-thirds); W. VA. CODE ANN. § 31-1-80 (1972) (60 percent present and affirming). For a discussion of dissolution see note 22 *infra* and accompanying text.

5. *Israel's, The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778, 779 (1952). Moreover, in a close corporation there is a special emphasis upon maintaining the existing coterie of owners, and restrictions upon the transferability of the stock may have been imposed to protect against stock purchases by outsiders. See notes 13-15 *infra* and accompanying text.

6. In this sense arbitration is the least drastic of the remedies,

such a resolution, however, the shareholders must rely upon a remedial arrangement, be it prescribed by the law of the jurisdiction or by their own governing documents.

### I. DEFINING THE PROBLEM

Practically, the terms dissension and deadlock have meaning only in the context of a particular close corporate situation, and therefore must be precisely defined in the by-laws or shareholders' agreement for the purpose of triggering any remedial provision. Academically, however, the first step in analyzing the scope and efficacy of the four remedial arrangements is to set forth the broad meaning of these two terms. Dissension simply means disagreement among shareholders. One shareholder might want the corporation to borrow money in order to expand, while another shareholder might be violently opposed to having the corporation incur a substantial liability. One shareholder might be anxious to have the corporation declare a dividend, while another might be firmly committed to a policy of reinvesting all earnings in the business. Dissension, it should be noted, has no relation to voting power. There could be just as much disagreement between a 90 percent shareholder and a 10 percent shareholder as between two 50 percent shareholders. Voting power may well determine the outcome of a disagreement, but counting votes is not the same thing as curing dissension.

The term deadlock is much more difficult to define than dissension. The clearest example of a deadlock occurs where there is at once a dispute between two 50 percent shareholders and between two numerically equal factions comprising the board of directors.<sup>7</sup> In such a case, courts have had no difficulty in finding that a deadlock exists.<sup>8</sup> A less clear case is presented

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making a decision rather than changing the decision-makers. See text accompanying note 28 *infra*.

7. The existence of such a deadlock and the allegation of mismanagement and abuse of authority caused the court to affirm an order overruling the demurrer to a petition for involuntary dissolution in *In re Involuntary Dissolution of Hedberg-Freidheim & Co.*, 233 Minn. 534, 47 N.W.2d 424 (1951).

8. Before ordering dissolution of a corporation, a court will require a showing of more than an incurable deadlock: that adverse and serious results flow from the deadlock or that the corporation can no longer function for the benefit of the shareholders. *In re Involuntary Dissolution of Lakeland Dev. Corp.*, 277 Minn. 432, 443, 152 N.W.2d 758, 766 (1967); *In re Involuntary Dissolution of Hedberg-Freidheim & Co.*, 233 Minn. 534, 539, 47 N.W.2d 424, 427 (1951). For a working definition

where there is a dispute between 60 percent and 40 percent shareholders, but a two-thirds vote is required for an action proposed by the 60 percent shareholder. The proponent could well claim that a deadlock exists. The opposing party, on the other hand, could maintain that blocking the proposed transaction is simply a legitimate exercise of voting power.<sup>9</sup> As this example demonstrates, the mere avoidance of either a 50-50 division in the stock ownership or an even-numbered board of directors will not necessarily prevent a deadlock from arising.<sup>10</sup>

The application of any of the four remedial procedures must be triggered by the occurrence of some event defined in the governing by-laws or shareholders' agreement.<sup>11</sup> If the existence of a "deadlock" is the triggering event, for example, the governing document should contain both a listing or other delineation of the types of issues sufficiently important to be included within the definition of a "deadlock" and a specification of the voting division among directors and shareholders which would constitute a "deadlock." To the extent the parties desire that dissension be included in or excluded from the triggering definition of "deadlock," they may use a definition which comprises more or fewer types of issues and a broader or narrower range of voting divisions.

## II. REMEDIES

### A. THE BUY-OUT

The purpose of the buy-out is to provide a market for the otherwise generally unmarketable stock<sup>12</sup> of a dissatisfied shareholder in a close corporation. Several different types of buy-out provisions may be used for this purpose.

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of deadlock in connection with the courts' statutory and equitable powers of dissolution see Annot., 13 A.L.R.2d 1260, 1262 & n.4 (1950). Presumably, by defining deadlock in the by-laws or shareholders' agreement for purposes of triggering a remedial arrangement, the shareholders can obviate such statutory definition and judicial construction. See note 22 *infra* and accompanying text.

9. Cf. *Aiple v. Twin City Barge & Towing Co.*, 274 Minn. 38, 143 N.W.2d 374 (1966).

10. Indeed, MINN. STAT. § 301.49(4) (1971) specifically refers to a deadlock of "two or more factions" as a ground for involuntary dissolution, thus apparently contemplating a situation more complex than that in *In re Involuntary Dissolution of Hedberg-Freidheim & Co.*, 233 Minn. 534, 47 N.W.2d 424 (1951), discussed in note 7 *supra*. See MODEL ACT § 97(a); *Israels, supra* note 5, at 786-87.

11. See generally *Israels, supra* note 5, at 791-92.

12. See note 5 *supra* and accompanying text.

### 1. *Equal Division of Stock—Two Shareholders*

Where the stock of a close corporation is equally divided between two shareholders, the governing corporate documents could provide that, upon the occurrence of a deadlock as defined, either party has the right to name a purchase price and to require the other party to elect to buy or to sell at that price.<sup>13</sup> In the limited category of cases which it fits, this arrangement provides an excellent method for separating the hostile parties, while at the same time preserving the corporation as an ongoing business. However, three conditions are essential before the arrangement is appropriate. First, each party must have sufficient assets, including funds obtainable by the corporation, to be able to buy out or retire the shares of the other.<sup>14</sup> Second, each party must be able to run the business without the help of the other. Third, unless the business is much more valuable than the jobs of the two shareholders with their close corporation, neither party can be dependent upon his job. Absent one or more of these conditions, the power in either party to require the other to choose between a purchase and a sale could become the power to oppress.<sup>15</sup>

This first type of buy-out arrangement is particularly attractive in the case of an incorporated joint venture between two viable independent businesses, each with its own management team and its own resources. Although an incorporated joint venture between such parties would take the form of a close corporation, the financial strength and independence of the joint venturers would typically be much greater than in a close corporation with individual shareholders.

An arbitration clause may be a useful adjunct to a buy-out provision. For example, under the buy-out arrangement just described, the shareholders might disagree as to whether a "deadlock" exists within the meaning of a particular definition of the circumstance that gives a shareholder the right to name a price

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13. The governing documents should provide, of course, that after one party names a price the other may no longer do so, but must choose between a purchase or a sale at the price named.

14. For some of the salient features of a redemption as opposed to a buy-out by a party see notes 19-20 *infra* and accompanying text.

15. Absent the first condition, for example, party A (sufficient assets) could compel the election by party B (insufficient assets), whose only choice would be to sell out. Absent the second condition, party A (independent) could compel the election by party B (dependent), whose only choice would be to sell out rather than to buy a business which (s)he could not manage. Thus the absence of any of the three conditions predetermines the choice made by the electing shareholder.

and require the other shareholder to choose between a purchase and a sale. If the definition of deadlock is cast in terms of various types of disputes and lists a dispute over a proposed "major" change in the corporate business, the shareholders might disagree not only as to the wisdom of the proposed change but also as to whether the proposed change is "major." To cope with such definitional disagreements, the document containing the definition of a deadlock could provide that any controversy over the existence of a deadlock is subject to arbitration.<sup>16</sup>

### 2. *Unequal Division of Stock—More Than Two Shareholders*

A buy-out provision is also useful for resolving dissension and deadlock where the corporate stock is not equally divided between shareholders, or where there are more than two shareholders. In these situations the minority interest is ordinarily the one which would be subject to the buy-out.<sup>17</sup> As "deadlock" is hard to define in multiple shareholder and uneven stock split cases,<sup>18</sup> the parties might agree to trigger the buy-out with a different event. For example, the buy-out could be triggered at the demand of the minority, at the demand of the majority or at the demand of either, as determined at the time the close corporation is organized or a new shareholder enters. There are dangers, however, in such a readily available buy-out procedure. If the majority is given the option to bring about the purchase of a minority interest, the majority may exercise its option to squeeze out the minority, especially if the job of the minority shareholder is valuable compared with his stock. On the other hand, if the minority shareholder has the option, the minority is free to liquidate its holdings even where there is no genuine dissension between the parties.

### 3. *Tax Considerations*

Except in the case of related shareholders falling within the attribution rules of the Internal Revenue Code,<sup>19</sup> the tax

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16. It makes no difference what the triggering event is called—a "deadlock," a "substantial controversy," etc. Arbitration concerns the question whether that event, as defined in the governing document, has occurred.

17. For such a buy-out the purchase price might be set by a formula, such as book value, or some agreed multiple of earnings before taxes and executive salaries or a combination of the two. Alternatively, the purchase price might be set at fair market value as determined by arbitration. See text accompanying note 29 *infra*.

18. See notes 7-10 *supra* and accompanying text.

19. INT. REV. CODE of 1954, § 317(b), defines redemption as a cor-

treatment of a redemption from corporate funds is ordinarily preferable to that of a buy-out from the personal funds of the remaining shareholder or shareholders.<sup>20</sup> However, the corporate statutes in many states require that the funds for such a redemption be drawn only from a corporate surplus.<sup>21</sup> There is a danger with the buy-out by redemption, therefore, that the corporation will have no surplus or that the surplus will be encumbered by preferential dividends accumulated but unpaid. Thus, shareholders who fail to confront a deadlock until the corporation is in financial trouble may discover their remedial arrangement has been statutorily nullified.

## B. EASY DISSOLUTION

Dissolution allows an otherwise locked-in shareholder to bring about a sale of the corporate business and a liquidating distribution by the close corporation. The purpose of arranging in advance for an easy dissolution is to circumvent both the judicial reluctance to grant an involuntary dissolution<sup>22</sup> and the

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poration's purchase of its stock from a shareholder in exchange for property. Under the Code such a transaction may be treated as a "dividend," taxable as ordinary income, rather than a "sale," taxable as a capital gain or loss. Where the departing shareholder is *not* related to another shareholder, the redemption is treated as an "exchange" under section 302(a), because the shareholder retains no stock in the corporation, INT. REV. CODE of 1954, § 302(b)(3). Where the departing shareholder is related to another shareholder or continues a nonownership interest in the corporation, however, the redemption will likely not be treated as an exchange. By the attribution rules of section 318(a), the departing shareholder is "considered as owning" the stock of the relative and thus does not fall within the safe harbor of INT. REV. CODE of 1954, § 302(b)(3). For a comprehensive discussion of corporate redemptions see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 9 (3d ed. 1971).

20. Retained corporate funds have been taxed only to the corporation, while funds distributed as dividends have been taxed to the individual as well.

21. *E.g.*, MINN. STAT. § 301.22(6) (1971), which provides:

A corporation may purchase or redeem shares of its own stock, whether pursuant to contract previously made or otherwise, only as follows:

(1) Out of earned surplus;

(2) Out of paid-in surplus; provided, that, if the corporation has outstanding shares entitled to preferential dividends or to a preference upon liquidation, then only such shares may be purchased or redeemed out of paid-in surplus.

22. Courts have been reluctant to allow involuntary dissolution, especially where the corporation continues to be profitable despite a deadlock. See *Kruger v. Gerth*, 22 App. Div. 2d 916, 255 N.Y.S.2d 498 (1964); *aff'd* 16 N.Y.2d 802, 210 N.E.2d 355, 263 N.Y.S.2d 1 (1965) ("Dissolution will not be compelled unless it be found that the dominant stockholders



voting requirement for a voluntary dissolution.<sup>23</sup> Thus the governing corporate documents can be framed to allow any shareholder to demand dissolution either at will or after the occurrence of a deadlock as defined.<sup>24</sup> To implement the dissolution arrangement, each shareholder could grant to a third party fiduciary, or perhaps to the other shareholders, an irrevocable proxy to vote all the stock of the corporation in favor of a voluntary dissolution whenever a shareholder is entitled to demand dissolution.<sup>25</sup>

There are several provisions which might accompany an easy dissolution arrangement. Such an arrangement might call for a delay of four to six months between the demand for dissolution and the implementation of the demand, both for the purpose of allowing a cooling-off period and for the purpose of allowing for advance planning. Also appropriate for use with an easy dissolution provision is a clause granting the corporation an option to redeem the stock of the party seeking dissolution.<sup>26</sup> The option would be exercisable by one party following a de-

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or directors have been 'looting' the corporation's assets and impairing the corporation's capital or maintaining the corporation for their own special benefit, thereby enriching themselves at the expense of the minority shareholders . . . ." 22 App. Div. 2d at 917, 255 N.Y.S.2d at 500); *In re Radom & Neidorff, Inc.*, 307 N.Y. 1, 119 N.E.2d 563 (1954) ("Even when majority stockholders file a petition because of internal corporate conflicts, the order [for involuntary dissolution] is granted only when the competing interests 'are so discordant as to prevent efficient management' and the 'object of its corporate existence cannot be attained.'" *Id.* at 7, 119 N.E.2d at 565). *But see, In re Involuntary Dissolution of Hedberg-Freidheim & Co.*, 233 Minn. 534, 538-39, 47 N.W.2d 424, 427 (1951) (involuntary dissolution "not predicated on insolvency"), discussed in note 7 *supra*; *Israels, supra* note 5, at 785-86. Moreover, courts might now apply partnership principles to allow dissolution. *See, e.g., In the Matter of Surchin v. Approved Business Co.*, 55 Misc. 2d 888, 286 N.Y.S.2d 580 (1967). *Cf.* note 8 *supra*.

23. *E.g.*, statutes cited in note 4 *supra*.

24. DEL. CODE ANN. tit. 8, § 355(a) (Cum. Supp. 1968) provides: "The certificate of incorporation of any close corporation may include a provision granting to any stockholder . . . an option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency." The parties can provide for arbitration in the event they disagree whether a deadlock has occurred which triggers the right to demand dissolution.

25. Such proxies might be terminable at will if held not to be "coupled with an interest" as required by a statute such as MINN. STAT. § 301.26(4) (1971). *See O'NEAL, supra* note 3, at § 5.36. To avoid this risk a commitment to vote in favor of voluntary dissolution under specified circumstances could be set forth in a shareholders' agreement. However, litigation might then be necessary in order to compel a recalcitrant shareholder to act.

26. *But see* note 21 *supra* and accompanying text.

mand for dissolution by the other. The redemption price would be a sum equal to the expected share of the proceeds which would be received by the party demanding dissolution if the corporation were dissolved. Should the shareholders be unable to agree on this figure, the anticipated amount of the liquidating distribution could be determined by arbitration.

As an alternative method of implementation, rather than providing for dissolution upon demand, the parties could limit the corporate life specified in the articles of incorporation to a short term of three to five years.<sup>27</sup> An unhappy shareholder might more readily decline to agree to an extension of the corporate life than take the affirmative step of making a demand for dissolution. Thus, the use of a sharply curtailed corporate existence makes dissolution easy to obtain, while simplifying the drafting requirements at the outset. On the other hand, in view of the long range relationship ordinarily intended when a close corporation is formed, the participants might resist a provision for a very short corporate existence.

Whatever the arrangement to make dissolution easily available, it is important to confine the device of easy dissolution to those situations where dissolution is not unduly burdensome or unfair to any shareholder. Thus, easy dissolution should be contemplated only where all shareholders have marketable skills for other jobs and where the tax consequences of dissolution are not significantly more onerous for one shareholder than for another. Unless these conditions are met, the use of an easy dissolution arrangement could permit one shareholder in the close corporation to use the threat of dissolution to oppress another.

### C. ARBITRATION

Since arbitration can play such a major role in the resolution of shareholder disputes in the close corporation, the arbitration remedy has been widely recommended by commentators.<sup>28</sup> As a result, arbitration clauses have undoubtedly often

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27. For a discussion of the analogous partnership principles see Israels, *supra* note 5, at 789-90. In a few states the expiration of corporate life is a statutory ground for involuntary dissolution. CAL. CORP. CODE ANN. § 4651(g) (West 1955); MINN. STAT. § 301.49(5) (1971); OHIO REV. CODE ANN. § 1701.91(A) (Page 1964). *But cf.* MODEL ACT § 97. In two states the extension of corporate life gives rise to the appraisal rights of dissenting shareholders. IDAHO CODE ANN. § 30-150 (1967); MINN. STAT. § 301.40 (1971). *But cf.* MODEL ACT § 80.

28. *E.g.*, O'NEAL, *supra* note 3, at § 9.08 *et seq.*; Note, *Mandatory*

been used in the hope of providing a quick, private, inexpensive and amicable means for resolving disputes between shareholders. Arbitration, however, is not as simple as it initially appears, and arbitration clauses can hardly be treated merely as part of the boilerplate. If an arbitration clause is used, the extensive, expanding and rather technical body of law on arbitration and award becomes applicable. Accordingly, arbitration is the most complex of the remedies under discussion.

Arbitration can be used as an independent remedial arrangement to resolve an issue upon which the shareholders are in disagreement. As already noted, arbitration can also be used incident to another remedial arrangement, such as a buy-out or easy dissolution, to resolve questions which may arise with regard to the existence of a deadlock or the fair value of the stock being purchased or redeemed. When used for the first purpose, arbitration will not often be a remedy for dissension, since the shareholder who loses may be unhappy with the award. Thus, arbitration as an independent remedy is essentially a device for deciding an issue which the shareholders and directors cannot decide. On the other hand, arbitration incident to a buy-out or easy dissolution arrangement provides relief both from a paralyzing deadlock and, to the extent desired, from mere dissension.

### 1. *The Arbitration Remedy*

Arbitration in the close corporate context actually embraces three distinct concepts. First, arbitration may be used as a litigation substitute to resolve a justiciable controversy. For example, an arbitrator might be asked to determine whether there is good cause for the discharge of a shareholder employee or whether a shareholder has diverted a corporate opportunity. In any dispute of this sort, the courts would be available to resolve the issue were there no arbitration clause. Second, arbitration may be employed as an appraisal procedure to determine the fair value of close corporate stock for purposes of a buy-out provision. Such an appraisal procedure, conducted by one or more arbitrators, must be distinguished from the use of an accountant to determine book value or earnings for purposes of a buy-out formula.<sup>29</sup> In Minnesota, for example, an appraisal by arbitration falls within the Uniform Arbitration Act, which provides for a

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*Arbitration as a Remedy for Intra-Close Corporate Disputes*, 56 VA. L. REV. 271, 279 (1970).

29. See note 17 *supra* and accompanying text.

hearing,<sup>30</sup> the right to counsel,<sup>31</sup> the right to cross-examination,<sup>32</sup> and other procedural safeguards.<sup>33</sup> On the other hand, the designation of an accountant to examine the books and apply a buy-out formula is binding at common law, but affords none of the procedural safeguards of the Uniform Arbitration Act.<sup>34</sup> Third, arbitration may be used as a means to resolve an argument over management policy. For example, the shareholders of the close corporation may disagree as to whether it should borrow money and expand, whether it should change to a new advertising agency, or whether the company should prefer manufacturer's representatives to employed salesmen. Such management policy questions are clearly not of the type a court would resolve.

## 2. *The Enforceability of Arbitration Agreements*

The enforceability of the three types of arbitration agreements just described depends initially on the state law governing arbitration clauses generally. At common law the courts enforced only agreements to arbitrate existing disputes, adhering to the theory that agreements to arbitrate future disputes deprived them of their jurisdiction.<sup>35</sup> In order to overturn this common law rule, many states adopted statutes declaring that agreements to arbitrate future disputes were enforceable. Some of these arbitration statutes are unclear, however, regarding the extent to which an enforceable arbitration agreement may cover disputes other than those cognizable in court.<sup>36</sup> As a result, there remains in many states a judicial reluctance to enforce agreements for the arbitration of non-justiciable controversies, especially when they touch upon questions of management policy.<sup>37</sup>

### a. Arbitration of a Justiciable Controversy

Although valid as a matter of state arbitration law, an arbitration clause directed at a justiciable controversy may be ren-

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30. MINN. STAT. § 572.12 (1971).

31. *Id.* § 572.13.

32. *Id.* § 572.12(b).

33. These safeguards include the right to compel attendance of witnesses and the production of records, the use of depositions, and a provision for sworn testimony. *Id.* § 572.14.

34. See *Sanitary Farm Dairies, Inc. v. Gammel*, 195 F.2d 106 (8th Cir. 1952); *Gammel v. Ernst & Ernst*, 245 Minn. 249, 72 N.W.2d 364 (1955).

35. O'NEAL, *supra* note 3, at § 9.14.

36. *Id.*; see note 46 *infra*.

37. O'NEAL, *supra* note 3, at § 9.15.

dered unenforceable by an overriding public policy. In *Wilko v. Swan*,<sup>38</sup> for example, the United States Supreme Court held that the right to a judicial forum conferred upon a plaintiff by the Securities Act of 1933<sup>39</sup> could not be waived in advance by the execution of an arbitration agreement. Similarly, other federal courts have held that disputes arising under the antitrust laws are not governed by arbitration clauses.<sup>40</sup> Thus, if a shareholder in a close corporation asserts a claim under the federal securities laws<sup>41</sup> or antitrust laws, an arbitration clause intended for use in resolving shareholder disputes might be unenforceable. Indeed, some New York decisions suggest that the same result might follow where the shareholder frames the claim as a derivative suit.<sup>42</sup> In the area of justiciable controversies, therefore, the major stumbling block to arbitration is the risk that public policy may render the arbitration agreement unenforceable.

#### b. Arbitration as an Appraisal Procedure

Where arbitration is agreed upon as an appraisal procedure in conjunction with the buy-out remedial arrangement, it is unlikely that any overriding public policy would apply to render the arbitration clause unenforceable. On the other hand, since

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38. 346 U.S. 427 (1953).

39. The Securities Act of 1933 § 12, 15 U.S.C. § 77l (1970), provides that the purchaser of a misrepresented security "may sue either at law or in equity in any court of competent jurisdiction. . . ." The non-waiver provision appears in § 14 of the Act, 15 U.S.C. § 77n (1970): "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the [Securities and Exchange] Commission shall be void."

40. *American Safety Equip. Corp. v. J.P. Maguire & Co.*, 391 F.2d 821 (2d Cir. 1968); cf. *A & E Plastik Pak Co. v. Monsanto Co.*, 396 F.2d 710 (9th Cir. 1968).

41. It should be noted that *Wilko* has been gradually eroded by subsequent decisions. Cases under the Securities Exchange Act of 1934, for example, have distinguished *Wilko* and recognized the enforceability of arbitration agreements. The reasons are two: first, section 28(b) of the 1934 Act, 15 U.S.C. § 78bb(b) (1970), creates exceptions to 15 U.S.C. § 78cc(a) (1970), the 1934 Act's nonwaiver provision; second, the 1934 Act cases have not involved the helpless individual investor protected by the strong policies of the 1933 Act. *E.g.*, *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209 (2d Cir. 1972); *Axelrod & Co. v. Kor-dich, Victor & Neufeld*, 451 F.2d 838 (2d Cir. 1971); *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766 (S.D.N.Y. 1968). For an excellent discussion of the demise of *Wilko* see 3 L. LOSS, *SECURITIES REGULATION* 1811-17 (2d ed. 1961), as supplemented by 4 L. LOSS, *SECURITIES REGULATION* 3932-34 (Supp. 1969).

42. O'NEAL, *supra* note 3, at § 9.19.

a dispute about stock valuation is unlikely to be regarded as a justiciable controversy, the enforceability of an appraisal provision depends upon the provisions of state arbitration law. In Minnesota and New York, for example, the applicable arbitration statutes are not limited to justiciable controversies,<sup>43</sup> and the Minnesota Supreme Court has said:

In contracts providing for arbitration of future controversies, the parties may narrowly limit arbitrability or they may comprehensively provide that all disputes, whether arising under the terms of the contract or growing out of their relationship—even though not cognizable in a court of law or equity—may be referable to arbitration.<sup>44</sup>

A dispute about the value of corporate stock for the purpose of a buy-out provision would appear to be the type of dispute “arising under the terms of the contract or growing out of [the parties’] relationship” which the parties may agree to refer to arbitration.<sup>45</sup>

### c. Arbitration of Management Policy Disputes

It is in a provision for resolving management policy disputes that the arbitration clause encounters the most substantial question of validity. In the first place, it is less likely that a state’s arbitration statutes will contemplate the resolution of such a dispute than, for example, a dispute over the value of stock.<sup>46</sup>

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43. See note 46 *infra*. For a discussion of other statutory provisions see O’NEAL, *supra* note 3, at §§ 9.14, .16.

44. Layne-Minnesota Co. v. Regents of the Univ. of Minn., 266 Minn. 284, 288-89, 123 N.W.2d 371, 375 (1963) (emphasis added).

45. Support for this position is found in the analogy to the statutory appraisal procedure for the benefit of a dissenting shareholder under MINN. STAT. § 301.40 (1971) (change of corporate purpose or extension of corporate life) and MINN. STAT. § 301.44 (1971) (merger). Indeed, subdivision 3 of section 301.40 specifically refers to the statutory appraisal procedure as an “arbitration.”

46. *E.g.*, MINN. STAT. § 572.08 (1971) provides:

A written agreement to submit any existing *controversy* to arbitration or a provision in a written contract to submit to arbitration any *controversy* thereafter arising between the parties is valid, enforceable, and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract. (emphasis added)

In New York non-justiciable controversies were formerly held not to be arbitrable. Application of Burkin, 1 N.Y.2d 570, 136 N.E.2d 862, 154 N.Y.S.2d 898 (1956). The arbitration statute was then amended to make arbitration agreements “enforceable without regard to the justiciable character of the controversy.” N.Y. CIV. PRAC. LAW AND RULES § 7501 (1963). Decided after this amendment, Vogel v. Lewis, 19 N.Y.2d 589, 224 N.E.2d 738, 278 N.Y.S.2d 236 (1967), *aff’g* 25 App. Div. 2d 212, 268 N.Y.S.2d 237 (1966), arguably supports the proposition that management policy disputes are now arbitrable in New York. The decision can be read nar-

With lingering notions of the justiciability requirement, moreover, a court may be reluctant to extend to an arbitrator the power to make a determination which the court would not undertake itself.<sup>47</sup> At the very least, therefore, one might expect that specific language including management policy disputes would be required by the court if the arbitration clause were to be broadly construed and enforced.

Even where state arbitration law permits the arbitration of non-justiciable controversies, state corporate law may prevent arbitration of management policy disputes. Corporate statutes generally entrust the management to the board of directors,<sup>48</sup> and such an arbitration provision might be held to be an invasion of the statutory powers of the directors.<sup>49</sup> Although some courts have been unwilling to enforce the delegation of management powers to an arbitrator, there have been indications in the more recent cases that this judicial attitude is changing.<sup>50</sup>

Yet a third hurdle to the enforcement of an arbitration clause in the context of a management policy dispute is the problem of implementing the arbitrator's decision. The shareholders might grant to each other or to some third party the proxies to vote for the implementation of the decision of the arbitrator. However, the shareholder whose views lost out in the arbitration proceeding could well be the key employee responsible for implementing the decision. Foreseeing an endless judicial supervision of the day-to-day conduct of the business in such a case, a court may be especially reluctant to find

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rowly, however, as limiting arbitration to questions involving the very continued existence of the corporation as opposed to questions involving the mere day-to-day management of the corporation. O'NEAL, *supra* note 3, at § 9.16. The Minnesota provision quoted above is neither as narrow as the old New York law nor as broad as the law in its amended form. Cf. notes 44-45 *supra* and accompanying text.

47. See notes 35-37 *supra* and accompanying text.

48. E.g., MODEL ACT § 35; MINN. STAT. § 301.28 (1971) provides that "the business of a corporation shall be managed by a board of directors . . . ."

49. In Minnesota, a partial answer to this problem is found in the case of *Hart v. Bell*, 222 Minn. 69, 23 N.W.2d 375 (1946), where the court sustained a shareholders' voting agreement as to management policy. Arguably, the *Bell* holding could be extended to management policy arbitration pursuant to the provisions of a shareholders' agreement. *Accord*, *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964), wherein the Illinois court sustained a shareholders' agreement which arrogated directorial powers over dividends and the selection of corporate officers. See also DEL. CODE ANN. tit. 8, § 350 (Cum. Supp. 1968).

50. See O'NEAL, *supra* note 3, at §§ 9.15-16.

an arbitration clause enforceable for the purpose of resolving a matter of management policy.<sup>51</sup>

### 3. *The Arbitrator's Qualifications*

The above three types of arbitration provisions differ not only in their enforceability but also in the qualifications they demand of the arbitrator. If justiciable controversies are to be resolved by arbitration, the shareholders will ordinarily prefer an arbitrator who is experienced and qualified in the art of judicial decision-making. For this purpose the parties might look to an experienced arbitrator or to a retired or former judge.<sup>52</sup>

Where the question referred to an arbitrator is the valuation of stock in a closely held corporation, there is little point in choosing an arbitrator whose primary experience has been in the field of judicial decision-making. Instead, the parties would ordinarily prefer one or more arbitrators who are experts in appraising the value of businesses of the type involved. Investment bankers, business brokers and acquisition executives may qualify as such experts. For the purpose of management policy dispute arbitration, the choice of an arbitrator presents an array of difficulties. The arbitrator must be at once someone capable of mediating between warring factions and someone who knows the industry well enough to make a sound management policy decision. The arbitrator cannot, however, be a competitor. In most cases, therefore, the only appropriate arbitrator would be a retired ex-

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51. A good example of the problem of enforceability is found in *Ringling v. Ringling Bros.-Barnum & Bailey Comb. Shows, Inc.*, 29 Del. Ch. 318, 49 A.2d 603 (1946), where the Chancellor held that a shareholders' agreement was not contrary to public policy in providing that the parties were bound by the instructions of an arbitrator as to how they must vote in the event of disagreement on matters of management policy. The arbitrator's decision was held enforceable upon the theory that the agreement "constitute[d] the willing party to the Agreement an implied agent possessing the irrevocable proxy of the recalcitrant party for the purpose of casting the particular vote." *Id.* at 335, 49 A.2d at 611. On appeal, however, the Supreme Court of Delaware rejected the irrevocable proxy rationale and held that the arbitrator's decision was unenforceable without the vote of the recalcitrant party. The court stated that the parties' agreement that the arbitrator's decision would be binding meant only "that each party promised the other to exercise her own voting rights in accordance with the arbitrator's decision. The agreement is silent about any exercise of the voting rights of one party by the other." 29 Del. Ch. 610, 619, 53 A.2d 441, 446 (1947).

52. Incumbent judges may be the best qualified to serve as arbitrators of justiciable controversies, but would be barred from serving in this capacity by Canon 5(E) of the ABA CODE OF JUDICIAL CONDUCT (adopted in 1972).



ecutive with a suitable background in the industry and without any current ties to a competitor. There can be little assurance in advance that such an individual will either be available or be willing and able to serve.

From the foregoing review of the enforceability of arbitration agreements and the considerations involved in choosing an appropriate arbitrator, only justiciable controversies and appraisals of stock value emerge as areas where arbitration is feasible. In view of the questions of enforceability and the difficulty of finding an arbitrator, it appears that arbitration is of doubtful practical value in the context of management policy disputes. If a policy dispute is so serious that the shareholders in a close corporation cannot reach agreement, the corporation is probably headed for either dissolution or a buy-out of one of the contending factions.

#### 4. *Arbitration Agreement Drafting Considerations*

One of the benefits of an arbitration clause is that it puts pressure on the contending shareholders to settle their differences rather than run the risk of a potentially unwelcome award by an outsider. This salutary effect has undoubtedly served to resolve justiciable controversies, stock valuation questions and, perhaps, even management policy issues. But some disputes are not settled. If an arbitration must actually be conducted, the precise language of the arbitration clause becomes important. When the arbitration clause is drafted, therefore, a number of somewhat technical points should be considered if arbitration is to achieve a just result in a contested case involving a close corporation.<sup>53</sup>

The draftsman of an arbitration agreement must examine both the corporate and arbitration law of the jurisdiction to determine whether the by-laws or the shareholders' agreement should contain the arbitration provisions. In Minnesota, for example, the Business Corporation Act does not explicitly authorize a by-law provision which requires arbitration.<sup>54</sup> More-

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53. The ensuing list illustrates drafting considerations which arise under Minnesota law.

54. MINN. STAT. § 301.24 (1971) provides: "The shareholders may make and alter bylaws . . . for the government of the corporation, the conduct of its affairs, the management of its property and business, and the transfer of its shares." While a court might decide that this language embraces a noncontractual by-law provision calling for the arbitration of some types of issues, the Uniform Arbitration Act presents

over, the Uniform Arbitration Act validates an arbitration clause only if it appears "in a written contract."<sup>55</sup> Hence, it is essential that the arbitration clause be contained in the shareholders' agreement rather than the corporate by-laws.<sup>56</sup> This requirement likely pertains in other jurisdictions unless the by-laws themselves are considered a "written contract" between the parties.<sup>57</sup> To perpetuate the enforceability of the agreement, the corporation's stock certificates should be stamped with the legend that they are transferable only to persons who consent to be bound by the agreement.<sup>58</sup>

Assuming the agreement is thus an enforceable contract, it should contain a provision enabling a court to enter judgment on the award of the arbitrator.<sup>59</sup> The American Arbitration Association recommends the provision in the Standard Arbitration Clause that "judgment upon the award rendered by the Arbitrator(s) may be entered in any Court having jurisdiction thereof."<sup>60</sup> This language, in conjunction with a requirement in the arbitration agreement that the arbitration be conducted

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a more dependable statutory basis for an arbitration clause. See note 55 *infra* and accompanying text.

55. MINN. STAT. § 572.08 (1971).

56. The arbitration clause should bind the corporation as well as the shareholders, since the arbitrable dispute may arise between a shareholder and the corporation rather than between two shareholders.

57. In an action brought by a member of defendant corporation to establish his membership rights, the Minnesota court has declared that a "by-law, though not expressly authorized [by statute], may operate as a contract between the corporation on one side and its members on the other so as to be binding on both . . . ." *Strong v. Minneapolis Auto. Trade Ass'n*, 151 Minn. 406, 409, 186 N.W. 800, 801 (1922). The court thus treated the by-laws as a contract between a corporate organization and its members for the purpose of establishing the members' interest in the corporation. *Accord*, *Pierce v. Grand Army of the Republic*, 224 Minn. 248, 28 N.W.2d 637 (1947).

The Nebraska court has treated the contents of a corporation's by-laws as an agreement between the parties organizing the corporation. *Baum v. Baum Holding Co.*, 158 Neb. 197, 62 N.W.2d 864 (1954). And a Wisconsin decision applied contractual rules of construction for purposes of interpreting corporate by-laws. *State ex rel. Siciliano v. Johnson*, 21 Wis. 2d 482, 124 N.W.2d 624 (1963).

58. Such a legend would reflect the provision in the agreement to the same effect. It should be noted that while such restrictions were once considered an unlawful restraint on alienation, they are now generally accepted. See, e.g., DEL. CODE ANN. tit. 8, §§ 202, 342, 347, 349 (Cum. Supp. 1968).

59. For a discussion of the scope of that award see note 69 *infra* and accompanying text.

60. This language also prevents any offset of other claims against the arbitration award. *Grudem Bros. Co. v. Great Western Piping Corp.*, 213 N.W.2d 920 (Minn. 1973).

in a particular state, insures that the courts of the state will have jurisdiction to enter a judgment on the award.<sup>61</sup>

In Minnesota the venue for any court proceeding pertaining to an arbitration can be lodged in the county where the agreement dictates the arbitration hearing be held.<sup>62</sup> In view of the statutory provisions on jurisdiction and venue, the arbitration clause might appropriately call for arbitration in the county of the corporation's principal place of business.

To minimize the risk that a party may attempt to evade the arbitration procedure by initiating a lawsuit, the parties should curtail their right to invoke the jurisdiction of the courts. To this end the arbitration clause can provide that the completion of the arbitration proceeding is a condition precedent to any litigation involving arbitrable subject matter.<sup>63</sup> The parties could also expressly waive any right which might otherwise exist to disregard the arbitration clause and bring a derivative suit or an involuntary dissolution proceeding because of dead-

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61. For example, MINN. STAT. § 572.24 (1971) provides: "The making of an agreement . . . *providing for arbitration in this state* confers jurisdiction on the court [defined as any Minnesota court of competent jurisdiction] to enforce the agreement . . . and to enter judgment on an award thereunder." (emphasis added) The recommended language conforms even more closely to the jurisdiction provision in the United States Arbitration Act, 9 U.S.C. § 9 (1970). See *Varley v. Tarrytown Associates, Inc.*, 477 F.2d 208 (2d Cir. 1973).

In Minnesota, the requirement that the arbitration be conducted within the state should not be necessary in the agreement, as district courts have a broad grant of general jurisdiction. MINN. CONST. art. 6, § 5 provides that "[t]he district court shall have original jurisdiction in all civil and criminal cases," and MINN. STAT. § 484.01 (1971) provides:

The district courts shall have original jurisdiction in all civil actions within their respective districts . . . in all special proceedings not exclusively cognizable by some other court or tribunal, and in all other cases wherein such jurisdiction is especially conferred upon them by law.

62. MINN. STAT. § 572.25 (1971). As MINN. STAT. § 572.12(a) (1971) authorizes the arbitrator to designate the precise locus of the hearing, the agreement need not specify a particular address within the county.

63. The arbitration clause sustained in *Layne-Minnesota Co. v. Regents of the Univ. of Minn.*, 266 Minn. 284, 287, 123 N.W.2d 371, 374 (1963), contained the following provision: "It is mutually agreed that the decision of the arbitrators shall be a condition precedent to any right of legal action that either party may have against the other." In some states, the statute of limitations does not apply to arbitration proceedings, and does not begin to run for purposes of a proceeding to compel arbitration until there has been both a demand and a refusal to arbitrate. *Har-Mar, Inc. v. Thorsen & Thorshov, Inc.*, 218 N.W.2d 751 (Minn. 1974). To avoid the risk of stale claims, the arbitration clause should specifically limit the time within which a demand for arbitration may be made.

lock. Even with such a waiver, however, a court might hold that the public policy behind the derivative suit or dissolution proceeding is so strong that the parties cannot contract in advance for a different remedy.<sup>64</sup>

If the parties require particular qualifications of the arbitrator, such as experience in the valuation of businesses or experience in a particular industry, these qualifications should be specified in the arbitration clause.<sup>65</sup>

Generally, unless an issue is clearly beyond the scope of an arbitration clause, the initial determination of arbitrability is made by the arbitrator, subject to later review by the courts.<sup>66</sup> Thus, if the arbitration clause merely uses broad language such as "any controversy or claim arising out of or relating to this contract,"<sup>67</sup> the hoped-for speed, privacy and economy of an arbitration proceeding could be lost in court proceedings to determine whether such language extends to a plainly non-justiciable controversy, such as a management policy dispute. Hence, the arbitration clause should clearly delineate the types of justiciable controversies, valuation questions, and management policy issues which are intended to be arbitrable.<sup>68</sup>

Under the Uniform Arbitration Act, an arbitrator is often granted the power to award relief which "could not or would not

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64. See O'NEAL, *supra* note 3, at § 9.19. For a discussion of other such overriding public policies see notes 38-42 *supra* and accompanying text.

65. MINN. STAT. § 572.10 (1971). See note 52 *supra* and accompanying text. Upon the subject of possible bias, MINN. STAT. §§ 572.12 (c), .19 (1) (2) (1971) refer to "neutral" arbitrators in such a way as to imply that some arbitrators need not be "neutral." In contrast, MINN. STAT. § 301.40(2) (1971), pertaining to the appraisal of dissenting shares in certain situations, requires valuation by "three *disinterested* appraisers, one of whom shall be named by the shareholders, another by the corporation, and the third by the two thus chosen." (emphasis added) Although arbitration agreements often call for two party-appointed arbitrators, together with a "neutral" arbitrator appointed by the party-appointed arbitrators, the objective judgment of all three arbitrators might better be assured by having all three either mutually agreed upon, court appointed, or appointed by the American Arbitration Association.

66. See, e.g., *Layne-Minnesota Co. v. Regents of the Univ. of Minn.*, 266 Minn. 284, 291, 123 N.W.2d 371, 376-77 (1963).

67. This language is part of the Standard Arbitration Clause of the American Arbitration Association.

68. Inasmuch as fraud in the inducement of an agreement is justiciable, but is arbitrable only if specifically included in the arbitration clause, it would be a mistaken assumption that broad language would encompass all justiciable controversies. See *Atcas v. Credit Clearing Corp. of America*, 292 Minn. 334, 197 N.W.2d 448 (1972).

be granted by a court of law or equity."<sup>69</sup> As a result, the parties to a close corporation shareholders' agreement might include some limitation upon the types of relief which the arbitrator can grant. To the extent the arbitration clause defines the issues subject to arbitration (for example, whether good cause exists for the discharge of a shareholder employee), such a limitation can be achieved by restricting the arbitrator to answering the question presented.

Although comprehensive pre-trial discovery may well be indispensable in preparing for a complex trial, unnecessary discovery could make a simple arbitration proceeding unduly slow and expensive. Perhaps as a result, the only discovery contemplated by the Uniform Arbitration Act is a procedure for taking depositions of witnesses who either cannot be subpoenaed or cannot attend the hearing.<sup>70</sup> To accommodate the interests of speed and adequate preparation the parties could, therefore, provide in the arbitration agreement that the arbitrator have discretion to authorize pre-arbitration discovery in accordance with either state or federal discovery rules.

The concept of burden of proof customarily plays no role in an arbitration proceeding. The Uniform Arbitration Act is silent on the subject, as are the Commercial Arbitration Rules of the American Arbitration Association. In the close corporation context, however, the relationship of the parties may be such that one or the other should bear the burden of proof. In that event the arbitration agreement should provide a burden of proof requirement with respect to some or all issues which may arise.

Where arbitration is used to resolve a justiciable controversy, a requirement in the agreement that the arbitrator issue formal findings and conclusions would seem to be a prudent safeguard. On the other hand, where the arbitration is conducted for appraisal pursuant to a buy-out provision, such a requirement would seem unnecessary. In the latter situation, the arbitrators essentially perform a jury function and should be required only to determine an appropriate dollar valuation, not to articulate a supporting rationale.

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69. UNIFORM ARBITRATION ACT § 12; *see also* MINN. STAT. § 572.19 (1971).

70. UNIFORM ARBITRATION ACT § 7(b); *see also* MINN. STAT. § 572.14 (b) (1971). *Cf. Bigge Crane & Rigging Co. v. Docutel Corp.*, 371 F. Supp. 240 (E.D.N.Y. 1973), where the court stayed pending litigation, but ordered discovery in aid of arbitration.

Under the Uniform Arbitration Act, the arbitrator is denied the power to award counsel fees in the absence of a provision to the contrary in the arbitration agreement.<sup>71</sup> Such a provision granting the arbitrator discretion over the award of counsel fees might help to discourage frivolous arbitration demands.

#### D. THE PROVISIONAL DIRECTOR

The final remedial arrangement to be treated in this Article is the provisional director. The purpose of providing for the appointment of such a director is to resolve close corporate voting deadlocks by adding to the board of directors a mediator who can cast a deciding vote. Such an arrangement seems best suited to resolve a deadlock in connection with management policy disputes. Since the provisional director could serve in an ongoing capacity, he would be in a better position than an arbitrator to see that his decisions are implemented. Furthermore, the provisional director might, on rare occasions, succeed in keeping the disputing parties together.<sup>72</sup> More likely, however, a dispute that is serious enough to necessitate the appointment of such a director will soon result in a buy-out or dissolution.

In the few states which have tailored special laws for the close corporation, the procedure for the judicial appointment of a provisional director is statutory.<sup>73</sup> Although there is no such express statutory provision in Minnesota, an equivalent arrangement is at least arguably permissible. The Business Corporation Act provides that where shares are held in a representative or fiduciary capacity and where the representatives or fiduciaries are equally divided, the court may "appoint an additional person to act with them in determining the manner in which such

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71. UNIFORM ARBITRATION ACT § 10; see also MINN. STAT. § 572.17 (1971).

72. Sometimes an attorney who enjoys the confidence of the parties can reconcile their differences simply by acting as an informal advisor.

73. For example, DEL. CODE ANN. tit. 8, § 353(a) (Cum. Supp. 1968) provides:

[T]he Court of Chancery may appoint a provisional director for a close corporation if the directors are so divided respecting the management of the corporation's business and affairs that the votes required for action by the board of directors cannot be obtained with the consequence that the business and affairs of the corporation can no longer be conducted to the advantage of the stockholders generally.

See also *id.* § 352(b); O'NEAL, *supra* note 3, at § 9.30.

shares shall be voted upon the particular questions as to which they are divided."<sup>74</sup> The Act has a like provision which pertains to stock held in a voting trust.<sup>75</sup> The court appointment of an additional person to act with equally divided representatives, fiduciaries or voting trustees would amount to the appointment of a provisional shareholder.

In order to use such a provisional shareholder to perform the functions of a statutory provisional director, the shareholders, assuming a 50-50 division of their stock and corresponding representation on the board of directors, could put their shares in a voting trust having the two shareholders as trustees. The by-laws could then provide that any questions on which the directors are deadlocked must be submitted to the shareholders for decision. If the voting trustees then could not agree, relief could be sought through the court appointment of a provisional shareholder.<sup>76</sup>

Alternatively, the parties could find a neutral third person to hold a separate class of stock with only a nominal equity interest in the corporation, but with the power to elect a provisional director in the event that the two director-shareholders were equally divided.<sup>77</sup> Since the Business Corporation Act requires that directors be elected by shareholders,<sup>78</sup> the use of a separate class of stock for the election of the provisional director is preferable to a provision purporting to give the appointment power to a non-shareholder.

Neither of the schemes just outlined, however, provides any convincing assurance of validity. If the shareholders were seriously divided, there would likely be a court test of the scheme, resulting in delay and expense even were the court ultimately to sustain the arrangement for the provisional shareholder or director. Moreover, even with a strong indemnification clause protecting the provisional shareholder or director, the difficulties of finding someone both able and willing to assume the responsibility might preclude the use of the arrangement.

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74. MINN. STAT. § 301.26(6) (1971).

75. *Id.* § 301.27(3).

76. Rather than seek court appointment of the tie-breaking trustee, the parties could provide in the trust indenture agreement some other mechanism for selecting the trustee.

77. See Recent Cases, 85 HARV. L. REV. 1676 (1972).

78. MINN. STAT. § 301.28(2) (1971).

### III. CONCLUSION

As the remedies for dissension and deadlock in the close corporation are far from perfect, the principals in the corporation should take every precaution to prevent conflicts from arising. If irreconcilable disputes do arise, however, the parties should have planned ahead for their resolution. Rather than relying upon statutory remedies, the parties should create their own remedies by drafting appropriate provisions in the by-laws or shareholders' agreement either at the time the close corporation is formed or at the time a new owner joins the enterprise.

The four remedial arrangements discussed in this Article must be suited not only to a particular close corporate situation but also to the applicable state law mandates. Absent a legislative or judicial imprimatur, the arrangements to provide both arbitration and a provisional director are of doubtful validity in many cases, especially where management policy disputes arise. In contrast, the arrangements to provide both a buy-out and an easy dissolution are generally supported by state law.



